Capital Adequacy
Program

Examination Objectives

To determine the adequacy and composition of the thrift's current and planned level of capitalization, considering the thrift's unique risk characteristics, overall condition, and planned direction.

To determine the effectiveness of management and the board of directors in actively monitoring, maintaining, and planning for capital adequacy.

To determine if the thrift's capital-related policies and procedures are adequate and are being adhered to by thrift personnel.

To determine the adequacy of audit and accounting practices and procedures, including the system of internal controls, as they relate to capital accounts.

To determine compliance with laws, rulings, regulations, and specific agreements with OTS, FDIC, or state authorities.

To ascertain the need for, or to initiate, corrective action (including acting under prompt corrective action provisions) when policies, practices, procedures, or internal controls are deficient, or when there are violations of laws, rulings, directives, or regulations.

Examination Procedures

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Level I

1. Obtain and review the information on capital provided in the UTPR, off-site monitoring reports, report of examination spreadsheets, latest examination report, latest audit reports, latest SEC reports, business plan, and correspondence with the OTS and other regulatory authorities. Consult with the examiner(s) reviewing the board of directors and committee minutes for any other items pertinent to the review of capital.

2. Through discussions with management and review of documents, determine if management has taken corrective action relative to:

    - Prior examination report comments and exceptions.

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- Internal and external audit exceptions.
- Any enforcement/supervisory actions and directives.

3. Review the thrift's compliance with relevant capital standards.

   - Compare capital levels with minimum PCA capital requirements, and determine the institution's PCA capital category.
   - Is the institution subject to any capital plan, capital directive, supervisory action, written agreement, or application condition regarding capitalization? If so, is the institution in compliance?
   - Is the institution in compliance with its internal business plan or board imposed capital targets?
   - Evaluate the thrift's risk profile including asset composition, interest rate risk, and other risks including off-balance-sheet risk.

4. Review trends in capital levels and ratios. Consider the prospects for continuing capital compliance, and consider whether management has planned for capital adequacy in line with anticipated growth. Consider whether the risk orientation of the institution is changing.

5. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

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Level II

6. Verify the reliability and accuracy of the institution's capital calculations. If necessary, revise the capital calculations and recheck the PCA level.

- Identify and reconcile capital accounts for activity since the last examination. Verify the accuracy of entries and outstanding balances. Be alert for changes in the capital accounts that the thrift has not recorded in the income statement.

- Identify and investigate any material differences between capital reported to OTS in the TFR, and capital reported in the audited financial statements and SEC filings (as applicable).

- Obtain the latest quarter-end TFR Schedule CCR including the institution's corresponding worksheet for calculating its capital levels. Obtain related work papers and review them for reliability. Refer to the TFR instructions, Schedule CCR, for additional guidance.

- Consult with the examiner completing Program 410, Financial Records and Reports, to determine if there are any reporting errors that could affect the institution's capital requirement calculations.

- Verify that the institution's capital calculations are accurate. Some of the following areas may be material to the reliability of the capital calculations:

— Subsidiary activities

✓ Are the activities permissible?

✓ Has the institution properly excluded or deducted its nonincludable subsidiaries?

✓ Have loans and advances to impermissible subsidiaries been deducted from capital and assets as required?

— Has the thrift deducted goodwill and intangible assets from capital and assets?

— Are assets subject to limitation appropriately handled?

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- ✓ Servicing assets
- ✓ Purchased credit card relationships
- ✓ Deferred tax assets
- ✓ Credit enhancing IO strips

— Are unrealized gains and losses on AFS securities properly handled?

— Are maturing capital instruments properly handled?

— Is the ALLL free of specific reserves?

— Has the thrift institution properly excluded from risk-based capital items that are not includable (for example, equity investments, reciprocal holdings of capital instruments)?

— Are delinquent single-family and multi-family loans properly risk weighted?

— Are high LTV loans properly risk weighted?

— Are LIP and commitments properly handled?

— Are post-period-end adjustments correct?

— Has the thrift properly treated assets sold with recourse?

— Is the thrift properly holding dollar-for-dollar capital against most residual interests? (And, is the thrift deducting any credit-enhancing interest-only strips that exceed 25 percent of Tier 1 capital?)

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7. Determine a level of capital that is appropriate for the risk profile. Where applicable, apply the capital guidance for subprime lending programs. If appropriate, recommend an individual minimum capital requirement, or use of the OTS reservation of authority.

- Consider the risk orientation and diversification of loan and investment portfolios. Do portfolios present excessive risk? Is the institution's risk orientation changing?

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- Identify and analyze the risks associated with off-balance-sheet activities. Analyze the economic risks or legal liability associated with activities such as asset securitization, trust administration, mortgage banking, or construction lending.

- Consider the institution's growth trends and goals. Review the effect of earnings and dividends on capital. Does the institution have the quality and level of earnings or balance sheet flexibility to support planned growth, structural changes, or new activities?

- Confer with the examiners assigned to Program 260, Classification of Assets, and Program 261, Valuation Allowances, to determine if specific allowances and ALLL are adequate. If not, determine the effect on capital. Ascertain the effect of current and potential losses.

- Consider whether asset portfolios have a higher than normal risk level for the particular type of asset. Protection against unanticipated or unidentified credit losses should be reflected in the institution's capital position. If an institution has a relatively high risk profile, its capital level should be commensurately higher.

- Evaluate capital adequacy of the thrift insitution after deducting assets of regulated subsidiaries and the capital needed to meet regulatory capital requirements at those subsidiaries.

- Consider the effect that service corporation and other subsidiary activities may have on the need for capitalization, including the potential liability of the parent thrift for obligations of the subsidiary.

- Evaluate the parent holding company's reliance on dividend payments from the subsidiary institution. Review related SEC filings for transactions between the institution and the holding company. Consider the appropriateness of earnings retention and dividend policies.

- Review the most recent external audit report (including management and internal control letter) and consult with the examiners assigned to Internal Controls and Internal Audit. Determine if deficiencies in internal controls and audit systems exist. Does an above normal level of operational risk require a higher level of capital?

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8. Assess management's capital planning process.

- Review management reports, such as the budget, strategic business plan, and capital plan to assess the adequacy and effectiveness of the institution's planning efforts.
- Evaluate the institution's access to capital markets. Consider the probability of success of planned capital-raising strategies.

9. If capital falls below the PCA well capitalized standards or if you determine that capital is inadequate or marginal relative to the institution's risk profile:

- Identify the appropriate PCA category. Discuss your determination with the EIC and OTS regional management.
- Determine if a supervisory or enforcement action is appropriate to address the capital deficiency or whether an IMCR Directive should be imposed. Discuss your recommendation with the EIC and OTS regional management. See Appendix A, Prompt Corrective Action Guidelines in Section 370, Enforcement Actions, for guidance.
- Confirm with your regional office that they are following PCA guidelines.
- Review any Guarantee of Controlling Parties for adequacy.
- Identify the need for any additional operating restrictions.
- Inform management of your conclusions, and the restrictions that apply to an institution that is less than well capitalized. The following restrictions apply:
  - — The mandatory and discretionary supervisory actions that apply to an institution that is less than adequately capitalized (Number 10 below).
  - — The pass-through insurance restrictions (Number 11 below).
  - — The broker deposit restrictions (Number 12 below).

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10. If the institution is less than adequately capitalized (as reflected in its TFR report, a final report of examination, or disclosed in a notice from OTS – see §565.3), you should review for compliance with the mandatory and discretionary supervisory actions. You can refer to §565.6 for a description of the mandatory and discretionary actions.

11. If the thrift institution is less than well capitalized, or if based upon your examination findings, you believe it may become less than well capitalized in the near future, review for notification of account holders subject to losing FDIC pass-through insurance coverage (see Regulatory Bulletin 33a):

- Determine whether the thrift has any employee benefit plan deposits or intends to accept any employee benefit plan deposits.

- If so, review the procedures developed to ensure compliance with FDIC regs at 12 CFR §330.14. This would include:

  — A determination that sample disclosures have been developed and shared with appropriate thrift personnel.

  — A determination that procedures have been developed to provide the appropriate disclosures to employee benefit plan depositors when opening a new account and when an existing empoyee benefit plan depositor (administrator or manager) makes a request for information.

12. Check for compliance with brokered deposit restrictions. Only well capitalized institutions may accept brokered deposits without restriction. If the thrift institution is not well capitalized, you may refer to Thrift Activities Handbook Section 560, Deposits and Borrrowed Funds, for the applicable restrictions and prohibitions on brokered deposits.

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13. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, and appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Examiner’s Summary, Recommendations, and Comments

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